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No. 86-1221

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1986

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WILLIAM J. HARNETT,
*Petitioner,*

v.

TOM J. BILLMAN,
CLAYTON C. McCUISTION,
*Respondents.*

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**On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit**

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## BRIEF FOR TOM J. BILLMAN AND CLAYTON C. McCUISTION IN OPPOSITION

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## QUESTIONS PRESENTED

1. Whether the federal law of *res judicata* should be applied to determine the scope and effect of a prior federal court judgment in a case where the exclusive jurisdiction of the district court was invoked to adjudicate alleged violations of the federal securities laws and the Racketeer Influenced and Corrupt Organizations Act and where the district court's pendent jurisdiction was also invoked over state tort claims, all arising out of the same common nucleus of operative facts.

2. Whether this Court should accept certiorari in a case where the Fourth Circuit recognized a "fraudulent concealment" exception to the doctrine of res judicata but determined, after reviewing the record, that such exception did not apply to this case.

TABLE OF CONTENTS


| | Page |
|---|---|
| QUESTIONS PRESENTED | i |
| TABLE OF CONTENTS | iii |
| TABLE OF AUTHORITIES | iv |
| STATEMENT OF THE CASE | 1 |
| THE FACTS | 2 |
| SUMMARY OF ARGUMENT | 5 |
| ARGUMENT | 6 |
| I. The Petition Should Be Denied Because The Scope And Effect Of A Federal Court Judgment Are Determined By Federal Law | 6 |
| II. The Petition Should Be Denied Because The Fourth Circuit Recognized The Existence Of A Fraudulent Concealment Exception But Based On The Record Facts, Determined That It Was Inapplicable In This Case | 10 |
| CONCLUSION | 11 |

## TABLE OF AUTHORITIES

*CASES* Page

*AEROJET-General Corporation v. Askew*, 511 F.2d 710 (5th Cir.), *cert. denied*, 423 U.S. 908 (1975) ..... 9
*Allstar Towing, Inc. v. City of Alexandria*, 231 VA. 421, 344 S.E.2d 903 (1986) ..... 10
*Answering Services, Inc. v. Egan*, 728 F.2d 1500 (D.C. Cir. 1984) ..... 9
*Bate v. Devers*, 214 VA. 667, 202 S.E.2d 917 (1974) ..... 10
*Cemer v. Marathon Oil Co.*, 583 F.2d 830 (6th Cir. 1978) ..... 9
*Federated Department Stores, Inc. v. Moitie*, 452 U.S. 394 (1981) ..... 7
*Gasbara v. Park-Ohio Industries, Inc.*, 655 F.2d 119 (7th Cir. 1981) ..... 9-10
*Harnett v. Billman, et al.*, No. 83-1029-A (E.D. Va. 1983) ..... *passim*
*Hayles v. Randall Motor Company*, 455 F.2d 169 (10th Cir. 1971) ..... 9
*Hunt v. Liberty Lobby, Inc.*, 707 F.2d 1493 (D.C. Cir. 1983) ..... 9
*Kern v. Hettinger*, 303 F.2d 333 (2d Cir. 1962) ..... 9
*Makariw v. Rinard*, 336 F.2d 333 (3d Cir. 1964) ..... 9
*Precision Air Parts, Inc. v. Avco Corp.*, 736 F.2d 1499 (11th Cir.), *cert. denied*, 469 U.S. 1191 (1985) ..... 9
*Semler v. Psychiatric Institute of Washington, D.C.*, 575 F.2d 922 (D.C. Cir. 1978) ..... 9
*Silcox v. United Trucking Service, Inc.*, 687 F.2d 848 (6th Cir. 1982) ..... 9
*Southwest Airlines Co. v. Texas Intern. Airlines*, 546 F.2d 84 (5th Cir. 1977) ..... 8
*Sunshine Anthracite Coal Co. v. Adkins*, 310 U.S. 381 (1940) ..... 7
*United States v. California & O. Land Co.*, 192 U.S. 355 (1903) ..... 7

TABLE OF AUTHORITIES—Continued


| *STATUTES AND RULES* | Page |
|---|---|
| Judicial Code | |
| 28 U.S.C. § 1331 | 2 |
| 28 U.S.C. § 1337 | 2 |
| Racketeer Influenced and Corrupt Organizations Act | |
| 18 U.S.C. § 1962 | 2 |
| 18 U.S.C. § 1964 | 2 |
| Securities Act of 1933 | |
| 15 U.S.C. § 77(b) | 2 |
| 15 U.S.C. § 77(g) | 2 |
| Securities and Exchange Act of 1934 | |
| 15 U.S.C. § 78(j) | 2 |
| Rule 10b-5, 17 C.F.R. § 240.10b-5 | 2 |
| *OTHER AUTHORITIES* | |
| 1B *Moore's Federal Practice*, § 0.406[1] (1984) | 8 |
| *Restatement (Second) of Judgments* (1982) | |
| Section 24 | 10 |
| Section 61 Tent. Draft No. 1 (1973) | 10 |
| Section 87 | 9 |
| Section 87 Comment a | 8 |

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## BRIEF FOR TOM J. BILLMAN AND CLAYTON C. McCUISTION IN OPPOSITION

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## STATEMENT OF THE CASE

In his Petition, plaintiff William J. Harnett ("Harnett") makes numerous factual misstatements and omits many relevant facts. Plaintiff omits the fact that in *Harnett, I*,[1] he invoked the exclusive jurisdiction of the federal court to seek damages for alleged violations of

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[1] *"Harnett I"* refers to *Harnett v. Billman, et al.*, No. 83-1029-A (E.D. Va. 1983), the first case filed by plaintiff in October 1983.

the federal securities laws' anti-fraud provisions and RICO.[2] (Pet. App. A4-A5.)[3] Similarly, plaintiff omits the fact that in *Harnett II*, he again invoked the exclusive jurisdiction of the federal court to adjudicate his claim of damages for alleged violations of the federal securities laws' anti-fraud provisions.[4] The federal and state law claims in both cases were based on the same common nucleus of operative facts. (Pet. App. at A3-A5, A11.) Plaintiff could not have maintained either *Harnett I* or *Harnett II* in the state courts.

## THE FACTS

By January 1983, respondents Tom J. Billman and Clayton C. McCuistion owned more than 90% of the stock of Equity Programs Investment Corporation ("EPIC") and also owned a majority of the stock of Community Savings & Loan ("CSL"). (Pet. App. at A3.) Petitioner William J. Harnett owned 1,250 shares of EPIC stock. (Pet. App. at A3.)

EPIC was the parent corporation of EPIC Mortgage, Inc. ("EMI"), a company engaged principally in mort-

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[2] In *Harnett I*, plaintiff sought damages for alleged violations of Section 10b of the Securities and Exchange Act of 1934 (15 U.S.C. § 78(j)), of Rule 10b-5 (17 C.F.R. § 240.10b-5) and of the Racketeer Influenced and Corrupt Organizations Act (18 U.S.C. § 1964; "RICO"). Exclusive federal jurisdiction was invoked under Section 27 of the Securities and Exchange Act of 1934, 15 U.S.C. § 78aa and under 18 U.S.C. § 1964.

[3] Citation to the Appendix to the Petition are referenced as "Pet. App."

[4] In *Harnett II*, plaintiff sought damages for alleged violations of Section 10b of the Securities and Exchange Act of 1934 and Rule 10b-5 and Sections 12(2) and 17(a), Securities Act of 1933 (15 U.S.C. §§ 77(b) and 77(g) (1982)). Exclusive jurisdiction was invoked under Section 27 of the Securities and Exchange Act of 1934, 15 U.S.C. § 78aa and Sections 1331 and 1337 of the Judicial Code, 28 U.S.C. §§ 1331, 1337.

gage origination and mortgage servicing. (Pet. App. at A3-A4.) On March 14, 1983, EPIC and its wholly-owned subsidiary, EMI, were merged into a wholly-owned service corporation of CSL. (Pet. App. at A4.)

Prior to the CSL/EPIC merger, the then existing mortgage servicing portfolio of EMI was spun off to a new company, EPIC Mortgage Servicing, Inc. ("EMSI"). (Pet. App. at A3-A4.) Harnett received 1250 shares of EMSI stock as a result of his ownership of EPIC stock. (Pet. App. at A4.)

EMI and EMSI entered into a subservicing agreement, dated March 1, 1983, under which EMI performed for a fee the servicing work for the mortgages in EMSI's portfolio. (Pet. App. at A4.) After the EPIC/CSL merger, EMI also became the servicer of new mortgages originated by the new EPIC/CSL entity. (Pet. App. at A4.) EMSI did not receive any of the new mortgage servicing business generated by the EPIC/CSL group but retained only the servicing rights in the portfolio originally spun off to it from EMI. (Pet. App. at A5.)

In October 1983, plaintiff initiated *Harnett I* in the United States District Court for the Eastern District of Virginia. There, plaintiff's federal and state claims were both based on allegations that Billman and McCuistion made fraudulent misrepresentations or omissions to Harnett in certain communications in late February and early March 1983 relating to the EPIC/CSL merger and the EMSI spin-off. (Pet. App. at A5.) Based on these allegations, plaintiff sought damages for alleged violations of the federal securities laws and RICO and for common law fraud and breach of fiduciary duty with respect to EMSI. (Pet. App. at A4-A5.)

Harnett sought and received extensive discovery throughout the *Harnett I* litigation of the business rec-

ords of EMI and EMSI as well as other companies related to EPIC and CSL. (Pet. App. at A5, A9.) In this discovery, Harnett received information enabling him to conclude that EMI was servicing mortgages and that EMSI's servicing portfolio had not expanded beyond that which it held at the time of its spin-off from EMI in early 1983. (*Id.*) Harnett also obtained a copy of the EPIC/CSL consolidated annual report, dated March 31, 1983, which disclosed the spin-off of EMSI, stated that EMSI received in the spin-off the "existing mortgage servicing operations of EPIC," and indicated that EPIC planned to enter into sub-servicing agreements with EMSI. (Pet. App. at A9.)

In February 1984, after all discovery had been completed, *Harnett I* was dismissed with prejudice. (Pet. App. at A5.) In February 1985, Harnett instituted the present action, referred to as *Harnett II*, against Billman and McCuistion in the United States District Court for the Eastern District of Virginia. (Pet. App. at A5.)

In *Harnett II*, plaintiff again asserted claims under the federal and state securities acts, for common law fraud and for breaches of fiduciary duty. (Pet. App. at A5.) The *Harnett II* complaint alleged that in the same communications at issue in *Harnett I*, Billman and McCuistion had misrepresented to Harnett that the new, spun off EMSI company would receive not only EMI's existing mortgage servicing business as of the date of the spin off but all of the future servicing business generated by the merged EPIC/CSL group, and that respondents failed to tell Harnett about the EMI/EMSI sub-servicing agreement, and, that EMI, not EMSI, was receiving the servicing business on new mortgages originated by the EPIC/CSL group. (Pet. App. at A5).

The Fourth Circuit held that the district court improperly failed to enter judgment for Billman and McCuistion on grounds of *res judicata*. (Pet. App. at A7.)

## SUMMARY OF ARGUMENT

The writ should be denied for the following reasons:

1. This case does not present the issue of whether federal or state law of *res judicata* should be applied to determine the scope and effect of a prior federal court judgment in a diversity case to bar claims alleged in a subsequent diversity case. In *Harnett I*, plaintiff sought damages for alleged violations of rights afforded him by the federal securities laws and RICO as well as for state common law torts. Similarly, in *Harnett II*, he sought damages for alleged violations of the federal securities laws as well as for state common law torts. All the claims in *Harnett I* and *Harnett II* were based on the same common nucleus of operative facts. (Pet. App. at A3-A5, A11.) Plaintiff could not have litigated his claims in either *Harnett I* or *Harnett II* in the state courts. Plaintiff invoked the exclusive jurisdiction of the federal court in *Harnett I* and *Harnett II* to adjudicate his federal claims as well as other pendent claims.

The district court in *Harnett I* adjudicated the merits of his claims, and the rulings of the district court were merged in one final judgment. Now, for the first time in his Petition, Harnett argues that the scope and effect of this federal court judgment should be determined by applying state law.

Harnett's argument ignores the fact that even if he had only pled his federal claims in *Harnett I*, his state claims arising from the same common nucleus of operative facts would have been barred by the judgment in *Harnett I* under the federal law of *res judicata*. There is no conflict among the circuits on this point. Courts and commentators uniformly recognize that the issue of the scope and effect of a federal court judgment must be decided by federal law. Any other result would erode the finality of federal court judgments. Determinations of the scope and effect of a judgment define the finality

of the judgment. Finality is an essential element of a court's authority and is a fundamental principle of judicial integrity and consistency.

2. The Fourth Circuit recognized the existence of a fraudulent concealment exception to the federal law of *res judicata* but determined after reviewing the record that such exception did not apply in this case. Harnett only disputes the Fourth Circuit's application of the exception based on the specific facts of record, hardly an issue worthy of review by this Court.

## ARGUMENT

### I. The Petition Should Be Denied Because The Scope And Effect Of A Federal Court Judgment Are Determined By Federal Law

In *Harnett I*, plaintiff invoked the exclusive jurisdiction of the district court to adjudicate his claim for federal securities fraud and RICO violations as well as for state common law torts. (Pet. App. at A4-A5; and *supra* at 2 n.2.) Harnett's federal claims in *Harnett I* were adjudicated on the merits and the rulings on all his claims were merged into one, final federal court judgment on all his claims.

*Harnett II* was likewise not a diversity case. In *Harnett II*, plaintiff alleged claims for alleged violations of the federal securities laws and invoked the exclusive jurisdiction of the federal district court to adjudicate these claims. *Supra* at 2, n.4.

The Petition inaccurately asserts that *Harnett I* and *Harnett II* were strictly diversity cases, and, therefore, *Erie* requires that state law of *res judicata* govern the determination of the scope and effect of the federal judgment in *Harnett I*. Because *Harnett I* and *Harnett II* involved federal and state claims arising from the same common nucleus of operative facts, petitioner's arguments based on diversity jurisdiction are irrelevant. The

district court had pendent jurisdiction over Harnett's state common law claims, and those claims would have been barred by the judgment in *Harnett I*, even if not pled. *Federated Department Stores, Inc. v. Moitie*, 452 U.S. 394 (1981) (Blackmun, J., concurring). The fact that such claims were pled could not narrow or affect the scope of the federal judgment in a case where the district court had exclusive jurisdiction over federally created claims arising from the same common nucleus of operative facts as the state claims.

A contrary result would promote claim splitting, cause uncertainty as to the finality of federal judgments and lead to the uneven administration of justice. For example, as petitioner has attempted to do here, federal securities law fraud claims would be split from state common law fraud claims and litigated separately in successive lawsuits in the hopes of having "two bites of the apple." This Court has continually expressed a strong policy of protecting the "conclusive character" of federal judgments and of requiring plaintiffs to litigate all their claims at one time. *Federated Department Stores, Inc. v. Moitie*, 452 U.S. at 398-399 and 401; *United States v. California & O. Land Co.*, 192 U.S. 355, 358 (1903).

The scope and effect of a judgment "define[s] finality and hence go[es] to the essence of the judicial function." *Restatement (Second) of Judgments*, § 87, Comment b, at p. 317 (1982). The Court has long recognized that the policy of finality as expressed in the doctrine of *res judicata* "is a rule of fundamental and substantial justice." *Federated Department Stores, supra*, at p. 401. Courts have uniformly held that federal law of *res judicata* should be applied to determine the scope and effect of federal judgments in cases involving federally created claims within the exclusive jurisdiction of the federal courts. *Federated Department Stores, Inc. v. Moitie, supra; Sunshine Anthracite Coal Co. v. Adkins*, 310 U.S. 381 (1940).

Courts and commentators have also uniformly stated that the scope and effect of a federal judgment must be determined by the federal law of *res judicata*, whether in a federal claim case or a diversity case. As stated in the *Restatement (Second) of Judgments:*

> The principle of finality is an essential element of a court's authority. The rules of res judicata express the quality of a court's authority, not only in general doctrine but in the technical particulars of the rules. The source of the federal courts' authority is in Articles I and III of the constitution. It is therefore appropriate to hold that, at least in the absence of some other provision by Congress, the effects of a federal judgment are a legal implication of those provisions. That proposition is expressed in modern decisions.

*Restatement (Second) of Judgments*, § 87 Comment a at p. 315 (1982) and § 87, Comment a, illustrations 1 and 2; 1B *Moore's Federal Practice*, § 0.406[1] at p. 272 (1984); *Southwest Airlines Co. v. Texas Intern. Airlines*, 546 F.2d 84, 94 (5th Cir. 1977).

Petitioner has not cited any precedent conflicting with the Fourth Circuit's opinion that the federal law of *res judicata* should be applied to determine the scope and effect of a federal judgment in a case involving federally created claims committed to the exclusive jurisdiction of the federal courts. Instead, petitioner attempts to misstate *Harnett I* as a diversity case.

Even if this case were inaccurately characterized as a diversity case, there is no split among the circuits.

Contrary to petitioner's arguments, every court of appeals which has considered the issue has held that the federal law of *res judicata* is applicable to determine the scope and effect of a prior federal judgment even in a diversity case. In addition to the Fourth Circuit, the Second, Fifth, Sixth, Eleventh, and District of Columbia Circuits have held that the federal law of *res judicata*

should be applied to determine the preclusive effect of a prior federal judgment in a diversity case. *Kern v. Hettinger*, 303 F.2d 333 (2d Cir. 1962); *AEROJET-General Corporation v. Askew*, 511 F.2d 710 (5th Cir.), *cert. denied*, 423 U.S. 908 (1975); *Cemer v. Marathon Oil Co.*, 583 F.2d 830 (6th Cir. 1978); *Silcox v. United Trucking Service, Inc.*, 687 F.2d 848 (6th Cir. 1982); *Precision Air Parts, Inc. v. Avco Corp.*, 736 F.2d 1499 (11th Cir.), *cert. denied*, 469 U.S. 1191 (1985); *Hunt v. Liberty Lobby, Inc.*, 707 F.2d 1493 (D.C. Cir. 1983). The holdings of these Circuit Courts of Appeals are in accord with Section 87 of the *Restatement (Second) of Judgments* that: "Federal law determines the effects under the rules of *res judicata* of a judgment of a federal court."

None of the cases cited in the Petition conflict with the Fourth Circuit's decision in this case. None of the cases cited by petitioner involve cases such as the present case where plaintiff has invoked the federal court's exclusive jurisdiction to adjudicate a federally created claim. Moreover, the cases cited by petitioner do not involve the issue of the scope and effect of a prior federal judgment. In *Hayles v. Randall Motor Company*, 455 F.2d 169 (10th Cir. 1971) and *Markariw v. Rinard*, 336 F.2d 333 (3d Cir. 1964), the courts stated, as the Fourth Circuit indicated here (Pet. App. at A8), that state law should be used to determine an issue of privity. Likewise, *Answering Services, Inc. v. Egan*, 728 F.2d 1500, 1506 (D.C. Cir. 1984),[5] and *Semler v. Psychiatric Institute of Washington, D.C.*, 575 F.2d 922, 925 (D.C. Cir. 1978), did not involve the scope of a prior federal judgment but turned on a determination of the underlying substantive elements of the substantive claim alleged in the subsequent suit. And, in *Gasbarra v. Park-Ohio Industries*,

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[5] The concurring opinion of then Circuit Judge A. Scalia accurately indicated that the decision turned on when the claim became actionable under state law, not on choice of law under *Erie*.

*Inc.*, 655 F.2d 1119 (7th Cir. 1981), the court relied on federal law and *Moore's Federal Practice* to apply the *Restatement (Second)* analysis used by the Fourth Circuit here. Applicable state law was the same as federal law.[6]

**II. The Petition Should Be Denied Because The Fourth Circuit Recognized The Existence Of A Fraudulent Concealment Exception But Based On The Record Facts, Determined That It Was Inapplicable In This Case**

Contrary to the Petition, the district court stated that petitioner did not have actual knowledge of the claim before the dismissal of *Harnett I*. (Pet. App. at A23.) The Fourth Circuit did not "overlook" this statement but specifically referenced it and held that actual knowledge of a claim is not a precondition to the application of the rules of merger and bar. (Pet. App. at A8-A9.)

The Fourth Circuit recognized "an exception to the general principle that lack of knowledge will not avoid the application of the *res judicata* rules is found in cases where fraud, concealment, or misrepresentation have caused the plaintiff to fail to include a claim in a former action." (Pet. App. at A9.) After reviewing the record in this case, the Fourth Circuit determined that given the extensive discovery Harnett received in *Harnett I*,

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[6] The Fourth Circuit did not determine whether its decision would have been different if it applied Virginia law. (Pet. App. at A7, n.1.) In *Bate v. Devers*, 214 VA. 667, 202 S.E.2d 917, 921 n.8 (1974), the Supreme Court of Virginia looked to the Restatement (Second) of Judgments, § 61 Tent. Draft No. 1 to hold that "cause of action, for purposes of res judicata may be broadly characterized . . . ." *See also, Allstar Towing, Inc. v. City of Alexandria*, 231 VA. 421, 344 S.E.2d 903, 905-906 (1986) (citing and relying upon *Bate v. Devers, supra.*) Section 61 Tent. Draft No. 1 (1973), relied upon by the Supreme Court of Virginia, is the precursor to § 24, *Restatement (Second) of Judgments* (1982) and is identical to § 24.

it was impossible to say that any concealment, even if it existed, acted to prevent the assertion of Harnett's fraud claim during the pendency of *Harnett I*. (Pet. App. at A9-A10.)

The Petition thus misstates the record. Petitioner is disputing the Fourth Circuit's record determination based on the specific facts of this case, which has no general import or precedential significance in other cases.

## CONCLUSION

For the foregoing reasons, the Court should deny the writ of certiorari.

Respectfully submitted,

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